

Achieving Excellence in Default Management

Improving the likelihood that every dollar owed is turned into a dollar paid

“We’re still nowhere near the bottom of the home pricing, and we are looking for that as the critical statistic which will create a balance fundamentally in the economy.”
— Alan Greenspan, Former Chairman of the Federal Reserve Board, August 1, 2008

While nobody can predict the future, the continuing housing crisis is increasingly having an impact far beyond the housing market, exposing the substantial risk of loss associated with consumer lending. According to the Federal Reserve Board, between the first quarter of 2006 and the second quarter of 2008, the average charge-off rate has increased for mortgage debt by more than 11 times, for credit card debt by 75% and for all other consumer debt by 125%. The rate of increase in the charge-off rate has accelerated since the end of 2007.

The current environment places a premium on having an effective default management operation. Senior management of banks and finance companies should be asking themselves — and be able to answer — a series of important questions about their default management operations. To the extent they do not know the answers to such questions, there likely is a substantial opportunity to enhance their default management operation.

Can you answer these important questions about your organization’s default management operation?

- Do you evaluate non-delinquent portfolios to determine borrowers’ stress levels and their likelihood of going into default?
- Have your loss mitigation strategies changed as the credit environment has deteriorated?
- How does the relative effectiveness of each alternative collection tactic vary by delinquency stage and behavior score?
- What would be the incremental value of hiring 100 additional collectors versus implementing other techniques to improve collections?
- How does the efficiency and effectiveness of staff vary by day of the week and time of day, and what implication do those findings have on the mix of full and part-time staff utilized?
- To what degree are in-house collectors more effective than outsourcing to an onshore, near-shore or offshore third-party collection operation?
- How effective is your “scenario analysis” at mitigating loss?
- Given the asset disposition alternatives for repossessed collateral, in which situations is each most effective?
- What is the likelihood of recovering deficiency balances and what implications does that have for in-house recovery strategies and placement of accounts with third-party collection agencies?

Background

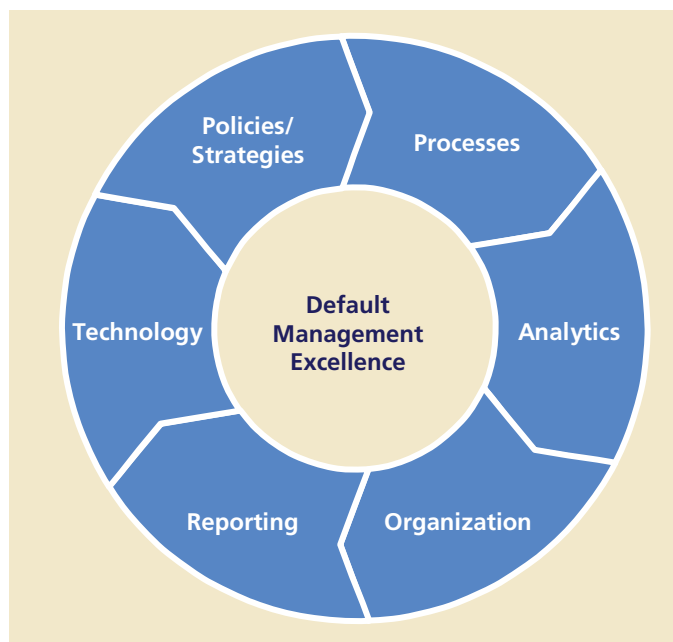
While many banks and finance companies believed prior to the current credit crisis that they had industry-leading default management capabilities, the spate of recent earnings announcements highlighting multi-billion dollars losses on their consumer loan portfolios, in addition to those on their investment portfolios, has called these beliefs into question.

Delinquency and charge-off rates have risen rapidly at most banks and finance companies. Many mortgage and home equity providers had experienced few losses historically and the collection operations they had set up to support their businesses in good times have proven inadequate to deal with the increasingly large number of delinquent accounts that today are often far more challenging to collect on than those that were delinquent in the past. In addition, these institutions are operating in largely uncharted waters for real estate finance — the value of collateral is often dropping rapidly, placing a premium on quick action both before and after a foreclosure to limit the ultimate loss exposure.

Auto finance and credit card providers also are experiencing challenges due to both the volume and severity of delinquent accounts even though they typically had experienced higher levels of delinquency and loss historically than mortgage and home equity lenders.

The volume of repossessed assets and the number of deficiency balances have also increased markedly and are likely to continue to do so for the foreseeable future, putting great strain on asset disposition and recovery operations as well.

For banks and finance companies to at least hold their own in the battle for customers' payment dollars, they must assess their current operations and find ways to more effectively deploy existing resources and implement increasingly sophisticated default management approaches as well as dramatically improve the outcome of the interaction between the agent and the customer.



Reducing bad debt through default management excellence

Maximizing the performance of a default management operation is highly complex. A wide range of capabilities — some highly quantitative and others more qualitative in nature — must be combined into a carefully integrated operation in order to achieve collections excellence. The capabilities required include: policies/strategies, processes, analytics, organization, reporting and technology.

Policies/Strategies

Effective default management operations start with a set of governing policies, grounded in applicable federal, state and local consumer protection regulations. Policies determine what is and what is not allowed at critical steps in the default management process. Policies may cover critical areas such as:

- The use of third-party providers (onshore/offshore) for early collection activities.
- Use of differentiated treatment strategies and modelling.
- Use of payment extensions or deferments as a temporary fix for a short term or temporary situation not as primary loss mitigation tool.
- Loss mitigation policies: The mortgage industry for the first time is facing depreciating assets. As a result, the speed at which lenders make decisions and the tools they utilize have significant and immediate impacts on the bottom line.
- Real Estate Owned (REO): The wave of REO is causing stress on the lenders' infrastructure but also the third-party providers who maintain the properties. This stress is materializing in lack of maintenance to properties, which further deteriorates property values.

Beyond the policies that govern specific collection tactics, important policies need to be established regarding staff training, call monitoring and compliance management. In addition, the disposition of accounts that enter collections can provide important information to guide future credit policy decisions for new customers.

Processes

Clear policies are not enough to deliver effective performance. Processes must be designed and implemented to turn policies into consistent actions that will mitigate losses. Leading-edge default management processes typically include the use of predictive and managed dialer campaigns, use of optimizers and automated workflow tools that schedule and track follow-up tasks, supported by passive collection activities such as pre-recorded calls and customer-specific collection letters, which can help maximize the efficiency of a default management staff for which there often are additional value-added activities worthy of being performed. Highly defined processes designed to limit fraud, renegotiate loan terms prior to default and trace skip accounts quickly are essential elements of a loss-mitigation program.

Another key feature of a continuous improvement culture is to build continuous champion-challenger testing into major processes. This approach allows a small portion of accounts to receive alternative challenger treatment tactics to determine whether those techniques are more effective, and therefore the current champion tactics should be dethroned.

Analytics

Advanced analytics embedded in the lender's risk management function form the foundation on which many of the key policies and processes are based. Given that both the current credit quality of customers and the current value of collateral can change rapidly over time, powerful analytical approaches are needed to assist in identifying the most appropriate treatment strategy at any point in time.

Predictive analytics provide insight into the appropriateness of future decisions based on the effectiveness of the past ones. Behavior scoring can help highlight which accounts demand the most aggressive treatment strategies, and which are likely to cure with little or no intervention. These scoring models are based on customer-specific data regarding product usage, credit history and historical delinquency, as well as additional data regarding demographic and behavioral characteristics at the ZIP code, census tract and block group level. In addition, models can be developed to estimate the ultimate amount of principal that is likely to be recovered from any current, delinquent or defaulted account.

Advanced analytics also underpin the selection and evaluation of champion-challenger tests. It is critical to be sure that the test is unbiased, meaning that there is nothing about the two groups selected that would lead to expected changes in performance other than those caused by the differential in the default management treatments. In addition, the size of test groups, the length of the test required and the differential effect that must be attained in order to conclude that the results are statistically valid must be determined.

Organization

In the end, default management's effectiveness results as much from people-related issues as it does from implementing appropriate policies and processes supported by advanced analytics. To be successful, banks and finance companies need, among other things, to build an organization and culture that expects continuous improvement and focuses on performance-based measures. Performance incentives are a critical element so that collector compensation is closely aligned with default management effectiveness.

Large organizations, such as large banks and finance companies with several lines of business, have additional organizational considerations. Decisions need to be made regarding which default management functions should be consolidated into a single operation that supports multiple lines of business and which ones should be handled separately by each business unit. There are advantages and disadvantages to each approach and company-specific characteristics will guide the decision. In any case, a centralized risk and default management governance structure helps maximize the visibility of default management within the larger organization, is consistent with more effective executive sponsorship of key projects, assists in setting priorities, promotes cross-functional and cross-organization collaboration, helps develop purchasing scale and reduces duplication of effort across the organization. Defining the risk and default management governance structure, along with appropriate roles and responsibilities, is a critical step.

Case Study: Top-Five Auto Finance Company

The organization wanted to migrate current multi-location default management center operations to industry-leading practice standards and apply consistent performance metrics:

- Drive consistency and optimize effective and efficient collections policies and processes across all locations
- Deploy consistent metrics and performance measures to track agent and center level performance
- Improve right-party contacts, penetration rates, promises taken, promises kept and dollars collected at the agent and center level

How Deloitte & Touche LLP assisted:

- Approach focused on evaluation, design, development and deployment of collections leading industry practices
- Project consisted of identifying, evaluating and recommending changes to the processes, policies, procedures, staffing levels, agent scheduling and performance reporting, consistent with collections industry-leading practices
- Project also consisted of establishing alternative collections treatment strategies to execute champion-challenger testing

Key results achieved:

- Improved collection agent efficiency and effectiveness by aligning risk management activities to improve risk segmentation and treatment strategy assignment within collections contact centers
- Reconfigured dialer strategies through a champion-challenger framework to optimize penetration and right-party contact rates
- Leveraged rules-based decisioning tools to segment customers by risk, to deploy differentiated collections treatment strategies by risk segment and days past due as well as to improve use of treatment strategy champion-challenger program
- Aligned collections policy and strategy to facilitate risk-based treatment strategies to support contacting the right accounts at the right time based on level of risk and days past due
- Created and deployed collection center staffing models resulting in reduction in staff size as well as expanded collector scheduling during prime time periods
- Improved availability, capture and tracking of risk metrics, dialer campaigns and collections agent metrics/data and reporting

Reporting

To become high-performing organizations, default management operations need to carefully measure and report to management on performance both in aggregate and at a highly granular and detailed level. However, a word of caution, granular does not equate to an excessive number of reports. Management should continually evaluate and rationalize the number of operational reports utilized by management.

For call center collection operations, understanding the extent to which right-party contacts, promises taken, promises kept, and dollars collected per hour vary by call center, collector, product, geography, delinquency tier, risk tier, and even time of day or day of the week is critical to developing training programs and staffing models. In addition, metrics, such as netback, allow management to evaluate alternative treatment strategies based on both the implementation cost and the dollars collected. These performance metrics can also be used to inform staffing models to set the mix of full- and part-time staff, as well as staffing levels by day of the week and time of day.

Performance metrics can be developed and deployed to support asset disposition and recovery performance activities as well. These metrics need to focus on the speed, cost and effectiveness of the myriad alternatives available once a decision to terminate an account has been made.

Performance metrics must be identified, systems set up to capture the necessary data, and metrics then regularly calculated in a timely fashion and distributed to appropriate parties so that they can take action.

Technology

Default management has become so complex that a bank or finance company cannot be a leading-edge performer without the support of leading-edge technology. Predictive auto dialers, blended inbound/outbound calling technology, account workflow tools, automated collection activities, and integrated tools to review old and record new customer interactions are essential elements of the technology needed to support a robust default management operation.

Maximizing performance requires extensive data analysis. Making accurate and complete data available to analyze requires a robust data warehouse, along with tools that allow vast amounts of data to be quickly extracted from the warehouse for further analysis.

The bottom line

The difference in effectiveness between a good default management operations and great one is substantial, particularly in these challenging economic times where hard-pressed consumers often are faced with the unfortunate situation of having to choose which of their many obligations to pay with the limited dollars they have available.

Default management operations that were viewed as adequate when the economy was more forgiving are proving to be anything but adequate when dealing with large numbers of debtors in financial distress.

Taking a hard look at the policies, processes, analytics, organization, reporting, and technology supporting a default management operation often reveals significant opportunities for improvement. One of the attractive features of improving a default management operation is that it affords the opportunity to test different approaches, carefully quantify the effect of each, and make changes that reflect this fact-based analysis. By establishing such a continuous improvement culture, along with the supporting tools required to sustain it, banks and finance companies can reduce their bad debt expense and position themselves well to deliver more revenue to the bottom line over the long term.

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